Commentary

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TAX REFORM IN A NEW LIGHT

Summary: The unprecedented overhaul of the U.S. tax system is forcing Canadians to look at reform of the tax system in a new light. The primary objective of tax reform in Canada should be to restructure the system -- sharply lowering personal and corporate tax rates and broadening tax bases -- in ways that enhance Canada's international competitiveness. Because of substantial differences in the two countries' economic structure and social values, the U.S. reform is not a perfect model for Canada. Achieving real progress in tax reform will require Canadians to undertake a widespread attack on existing tax preferences, to accept a broadly based sales tax and to integrate the personal tax structure and the social welfare system to ensure that social benefits are directed to those who really need them.

Oliver Wendell Holmes, Jr., once said that "taxes are the price that we pay for civilization." While there is a great deal of truth to this statement, Canadians have found that the price of civilization comes pretty high these days -- and is likely to become higher yet. Given Canadians' apparent unwillingness to come to grips with the level of government expenditure and the taxation that this implies, we are now turning to the prospects of improving our position by changing the structure of the tax system.

There have been tax reforms in Canada in the past, including the massive 1971 overhaul following the Carter Commission report and the Benson White Paper. While the 1971 process developed new insights and made some needed structural improvements in the tax system, it is now obvious that the result was flawed by compromise and excessive fine tuning. Subsequent annual avalanches of changes to the tax laws have confirmed the failure of the tax structure: it is now a dull year indeed when there are not at least 100 pages of amendments to income tax legislation alone.

The Canadian tax system is not the only one that has been in a constant state of turmoil for the past two decades. In the United States, the United Kingdom, Europe, and elsewhere, legislators have been devising new patches and bandaids for their increasingly leaky tax structures, in attempts to cope with a never-ending cycle of burgeoning government deficits and a general unwillingness to restrain government spending.

What We Have Learned Since Carter

As Canadians return to the scene of the crime in visiting tax reform once

again, we need to recognize that there has been a revolution in thinking since the heady days of Carter and horizontal and vertical equity. For one thing, we have lost some of the innocence of the 1960s, when it seemed that the economy was going to boom forever and that the main problems were how to redistribute increasing wealth and what to do with leisure time. Twenty years later, after sky-high inflation, rock-bottom recessions, and roller-coaster economic and political trends, Canadians have a different appreciation of the problems.

We have also lost, over the intervening period, some of our faith in the ability of governments -- of whatever political stripe -- to solve all of our problems. There has always been a widespread, if naive, belief among Canadians that new government programs can deal with regional and social injustice as well as solve all economic problems. But we now look out over a wasteland of economic fine tuning and government intervention, littered with such stellar examples as the Glace Bay heavy water plant, the Maislin bailout, Via Rail subsidies, the Come-by-Chance oil refinery, the dairy price support program, UIC ripoffs, SRTCs, MURBs, film deals, and seismic tax flips. The continuous flow of money down the insatiable drain of misguided government incentives, industry bailouts, social bribery, and tax boondoggles may have convinced at least a few Canadians that the appropriate role of government in direct intervention in the economy is more limited than they once thought.

We also may have learned a few things about taxation theory. There has been a gradual trend toward accepting the merits of a greater reliance on taxes on consumption rather than on income. The Meade Commission report in the United Kingdom, the Treasury Department's "Blueprint for Tax Reform" in the United States, the Macdonald Commission report in Canada, and other important studies all have advocated, in various ways, that tax burdens should be shifted from income to consumption. To oversimplify it, the proponents of consumption taxation argue that more of the tax burden should be based on what people take out of society, in the sense of what they consume, and less on what they contribute, which might be measured in part by their income. In economic terms, income taxation drives a wedge between savings and consumption and distorts economic choice away from investment in favor of current spending, since both the income out of which savings are made and the return from those savings are taxed.

The growing cynicism about government may have led to a further conclusion: that any tax is a bad tax, and that the country is better served by government's raising its money from a range of different taxes, rather than relying largely on any one tax where heavy burdens will inevitably produce distortions and encourage avoidance. This is one further reason to reverse the growing dependence on the personal income tax, which now generates almost one-half of all tax revenue in Canada.

Another possible change over the past 20 years has been a shift in Canadians' appreciation of the costs of income redistribution. At one time, it was thought that the economic costs of such redistribution were relatively modest. More recent studies have indicated, however, that the cost of taking an additional dollar from one person through the tax system and redistributing it to another person through the social welfare system could range from $1.50 to $3.50. Of course, the high cost of income redistribution does not mean that the less-advantaged members of society should not receive support, but it is important to recognize the costs involved.

Why Tax Reform Now?

There is a growing body of opinion, supported in the Macdonald Commission report and elsewhere, for the rationalization and modernization of tax structures with the primary objective of

achieving a tax system that will result in a lower drag on economic growth. The Canadian tax system, while not the world's worst, does suffer from some major structural defects that have reduced the economy's competitiveness and robbed Canadians of jobs, income, and opportunities:

- Substantially different effective tax rates exist on investments in different industries, in different types of assets, or made through different business structures. The inevitable result is a misallocation of resources and a reduction in efficiency, output, and employment.
- A large number of hidden taxes -- such as capital taxes, sales taxes on business inputs, payroll taxes, and so on -- are demanded of those who can only include them in their costs to be passed on to others. Canada's high reliance on hidden taxes increases business costs, placing domestic industries at a disadvantage against foreign producers in both domestic and foreign markets. These same hidden taxes also reduce political accountability.
- The present system is biased against equity investment and risk taking. Income is always taxable, but losses are not always deductible. And, since there are important elements of double taxation left in the taxing of corporate profits, the system discourages equity investment in favor of borrowing.
- The present system does not recognize inflation, and business profits are increasingly overtaxed as inflation rises.
- Because of all of the foregoing, the present system is complex; it is, therefore, uncertain and subject to frequent change.

Tax Reform Is as Canadian as Apple Pie

Tax reform has always been one of the Mulroney government's stated objectives. Finance Minister Wilson's first preference was to undertake a review of the tax system on a piecemeal basis over an extended period. The ostensible reason for this approach was that any radical and immediate restructuring of the system would shake business confidence. A contributing cause undoubtedly was the government's practical appreciation of the difficulty of coming to grips with yet one more complex and politically explosive issue.

In the meantime, however, the United States rather unexpectedly came through with an unprecedented reform of its tax system, a reform that -- directly and indirectly -- will put much more immediate pressure on Canada's tax system and on the Canadian economy. The U.S. tax reform is forcing Canadians to look at reform of the system in a new light. But the U.S. tax changes are only one reflection of a new wave of tax policy developments sweeping the world. While the process naturally differs from country to country, it is possible to pick out some common threads of tax rationalization: a new emphasis on lower tax rates and economic efficiency, instead of on government fine-tuning manipulation of economic effort and the rhetoric of instant income redistribution.

The United Kingdom made a partial start at overhauling its tax system in 1984 when it cut the corporate tax rate to 35 percent, but at the price of abolishing inventory allowances and superfast depreciation deductions. Even before this, the United Kingdom had cut its sky-high personal tax rates by doubling its value-added (VAT) tax.

In Australia, Bob Hawke's Labour government got a bit of a bloody nose during its 1985 tax reform efforts. But it still managed to follow through with a program of significantly lower personal tax rates (to a 50 percent maximum), some cutback in general incentives, the full inclusion of indexed capital gains on new assets in the tax base, and the integration of corporate and personal taxes. Perhaps ominously for Canada, Mr. Hawke did have to back down -- because of opposition from labor unions, consumers, and farmers -- from his plans to shift some of the burden of Australia's present

income tax structure to a new and broadly based sales tax.

In New Zealand, another Labour government has just implemented an even more radical reform, including lower personal tax rates, a cutback in incentives and special deductions, and the introduction of a 10 percent VAT on virtually all goods and services (including food).

In France, the new moderate-right government has moved to reduce the corporate income tax to 45 percent from 50 percent, with a further cut scheduled to 42 percent, and to reduce taxes for high-income individuals.

West Germany cut its personal tax rates in 1985, and further relief is now being proposed for taxes on business profits and personal income.

In Japan, tax reform recommendations brought forward in 1984 included introducing a major indirect tax, possibly a European-style VAT, and a suggestion that reductions in personal and corporate tax rates might be appropriate. While the introduction of a broadly based consumption tax has not been greeted with enthusiasm in Japan, consideration is being given to a 5 percent VAT, effective in 1988, and an accompanying cut in income taxes.

U.S. Tax Reform

For Canadians, by far the most important tax development abroad is the tax reform bill signed by President Reagan on October 22, 1986. This U.S. reform package involves a spectacular cut in tax rates: it reduces the top federal personal tax rate to 28 percent from 50 percent and cuts corporate rates to 34 percent from 46 percent. It also includes an equally spectacular broadening of the U.S. tax base, with special deductions, accelerated depreciation, investment tax credits, tax shelter claims, and what have you being massacred left and right in order to make up for the revenue loss. The U.S. tax changes are complex in the extreme, and it is fair to say that neither the technicians who drafted the legislation nor the politicians who passed it fully understood what they were doing. What the new rules really represent is an unprecedented redistribution of tax burdens, with large numbers of both winners and losers. The reform has turned a tax system riddled with boondoggles, special rules, and multiple deductions into a system with one of the broadest income bases and lowest tax rates of any developed country.

The winners in the U.S. reform process appear to be the large number of personal taxpayers, particularly at the bottom end, who will benefit from increased exemptions and lower tax rates, as well as those upper-income individuals who had not relied previously on tax shelters or tax preferences. At the corporate level, the winners are likely to include many in the services sector -- such as investment dealers, retailers, and so on -- some high-tech companies, and many businesses in which fixed capital investment is not a major factor and where the lower corporate rates more than make up for the loss of business preferences.

The losers in the reform process will include high-income individuals who formerly offset a good deal of their income with tax shelter deductions or who were in the habit of realizing capital gains (now to be fully included in taxable income). Among businesses, the losers generally will be the smokestack industries and all those in which heavy capital investment is required, including real estate, utilities, and airlines. Many U.S. corporations, even if they manage to sidestep most of the specific base-broadening measures, may be caught by the new 20 percent minimum corporate tax, a particularly hard-biting supplement that includes in its base, for a transitional period, the profits that a corporation reports to its shareholders.

In total, the U.S. tax changes will mean significantly reduced incentives for

many types of new capital investment. There will be an increase in personal buying power as personal tax cuts come into effect in 1987 and 1988, but this will be accompanied by a reduction in corporate cash flow. Individuals tend to save less than do corporations, so the U.S. savings rate conceivably could decline still further.

The ultimate unknown is what effects the reform will have in the long term on incentive and personal effort, on restructuring of investment, and on possible efficiency gains through a reduction in government intervention in the economy. The best tentative view seems to be that, in the short term, the changes will be unfavorable but that they could prove mildly positive in the long term.

A Model for Canada?

The U.S. tax reform has accelerated the pace, and will influence the direction, of tax change in Canada. But because of the substantial differences between the two countries, the U.S. changes are not a perfect model for Canada to follow. Finance Minister Wilson has already made this point, although he neglected to add that the most compelling reason for not copying the U.S. changes is not because we do not want to but because we cannot.

Government spending as a percentage of GDP is substantially lower in the United States, even with its expensive military establishment, than it is in Canada, with its vaunted social safety net. Furthermore, the Canadian tax system does not contain as much in the way of special treatment, incentives, and boondoggles as did the previous U.S. system, which means that base broadening will not produce sufficient revenue to permit tax rates as low as those in the United States. Despite the many complexities and likely failures of the U.S. tax reform, its lower personal and corporate rates are a major and valued achievement, but a similar achievement may lie just beyond Canada's grasp.

The U.S. tax reform contains serious flaws that should be recognized. Even though the U.S. federal deficit is lower than Canada's as a percentage of GDP, the United States has not been much more successful than has Canada in bringing that deficit down. The tax reform package was intended specifically to be revenue neutral, but the "revenue neutrality" of the Tax Reform Act is very much front-end loaded with one-time revenue gains that result from taxpayers' being forced to use new and more onerous tax accounting methods. If the reform fails to jolt the United States into stronger economic growth, the current U.S. deficit -- already likely over U.S.$180 billion -- could take a big leap after the temporary revenue gains are over.

The U.S. tax reform continues the long-standing U.S. tradition of not providing any integration of corporate and personal taxes. Instead, technical changes have emphasized the separateness of the corporate tax. From a Canadian viewpoint, copying the U.S. approach would mean abandoning the dividend tax credit. Such a step would be retrograde. It would prevent Canada from achieving a more neutral tax system that avoids a double tax on corporate income. Since the dividend tax credit is only available to Canadian residents, it would also fly in the face of Canada's long-standing policy of encouraging Canadian ownership of Canadian business.

Another structural flaw in the U.S. reform is that the general corporate tax rate of 34 percent exceeds the maximum personal rate of 28 percent. This feature, combined with the continuing lack of integration of corporate and personal taxes, will provide an incentive for the transfer of as much business activity as possible out of corporations and into limited partnerships and other forms where income is taxed at the lower personal rate.

A major difference between the positions of the two countries relates to consumption taxes. The United States has no general federal sales tax, relying

almost entirely on corporate and personal income taxes. Canada has an antiquated and perverse single-stage federal manufacturers' sales tax universally recognized as being in a terminal state of illness. But Canada also has a personal income tax that is a mixture of a true income tax and a tax on consumption. (Elements of consumption taxation are introduced through the allowances for some registered personal savings, the deduction of $1,000 of annual interest and dividend income, and even the $500,000 capital gain exemption.)

U.S. Tax Reform: Who Is Made Uncompetitive?

In the United States, industry largely greeted tax reform with hostility, claiming that it would make U.S. businesses uncompetitive with their foreign competitors. In Canada and in other countries, however, it has been argued that the lower U.S. corporate tax rates will provide devastating competition for local industry, which may move to the United States to take advantage of the tax reform bonanza.

Which view is correct? The U.S. changes result in such complex shifts in burdens that both points of view could be right simultaneously, although both probably are overstated. But what is of vital importance is that even though the aggregate tax burden on U.S. businesses has been increased substantially, marginal tax rates on some new income also have been dramatically cut. The aggregate tax hikes get the most immediate attention, but the rate reductions may prove of growing significance in the long term.

The Threat of U.S. Reform

Canadians have to recognize that the U.S. reform reduces the attractiveness of most foreign investment to U.S. corporations. The lower U.S. corporate tax rates, together with changes in the foreign tax credit rules, will put foreign profits at a relative disadvantage to U.S. income. Multinational corporations have a natural tendency over time to shift deductions and claims to where the tax rates are higher -- in this case, Canada -- and to shift income to where the tax rates are lower -- that is, to the United States. With Canada's open economy and with multinationals making up such a large part of the Canadian business community, if corporate tax rates in Canada remain substantially higher than those in the United States, there could be a painful erosion of the Canadian tax base and Canadian tax revenues.

For individuals, unless Canada takes action to revise its tax system, the typical maximum U.S. personal tax rate (federal and state combined) will be in the mid-30s by 1988, while in Canada it will be close to the mid-50s -- a massive 20 percentage point differential. U.S. residents, of course, will have higher social security taxes than will Canadians, and they will lack the ability to deduct large retirement income contributions. U.S. taxpayers, however, will still be able to claim mortgage interest and taxes on up to two homes.

For corporations, combined U.S. federal and state corporate rates typically will fall to about 37 or 38 percent or so by 1988. In Canada, meanwhile, combined federal and provincial corporate rates -- under present law -- will remain around 50 percent, or about 12 or more percentage points higher than those in the United States. Even Canada's special lower tax rate on corporate manufacturing and processing profits will remain about 43 percent by 1988 (although lower in Quebec).

For a number of practical reasons, not the least of which is that the United States may not want us, there is not likely to be any flood of Canadians or Canadian money to the United States. But the lower U.S. rates are attractive enough to entice a modest number of Canadians, and Canadian businesses, to the United States. Moreover, those most

attracted will be the mobile, high-income earners and the high-tech and services businesses that Canada can least afford to lose.

Canadian Tax Reform

The overwhelming pressure to contain the federal deficit already had forced Finance Minister Wilson to turn once again, in the February 1986 budget, to major tax increases. These increases placed even more weight on Canada's creaking tax structure and, through the elimination of the investment tax credit and inventory allowance, they pre-empted areas of corporate tax reform without giving much in the way of offset. Indeed, the hallmark of tax change in Canada over the past two years has not been tax reform but tax increases: federal and provincial governments together have imposed over $6 billion in new tax hikes.

The Department of Finance was prepared last June to unveil a major discussion paper on a new business transfer tax (BTT) -- really just a disguised value-added tax. But by then, the United States was moving ahead on its massive tax changes. It was also evident that the cabinet did not have any great taste for plunging ahead with a BTT that would involve over a million businesses having to collect tax on food, children's clothing, services, and so on without there being some offsetting benefits on the table. Accordingly, the Finance Department switched horses in mid-year and finally committed itself to a review of the entire federal tax structure.

The October Tax Reform Statement

In October 1986, the Finance Department issued a statement entitled "Guidelines for Tax Reform in Canada." This document proved to be rather like a mu-mu on an attractive girl -- more notable for what it conceals than for what it reveals. But the guidelines do set out some broad directions for what is likely to be the biggest overhaul in the Canadian tax system in the past 15 years:

- A significant reduction in both personal and corporate tax rates in response to the U.S. cuts and as a means of introducing real incentives into our system. At a guess, the Finance Department is likely to try to reduce the top combined federal and provincial corporate rate to perhaps 40 percent or a bit higher, and the top personal rate to just above this.
- Some "simplification" of the personal rate structure, likely involving far fewer rate brackets and a flattening of marginal rates, but with some specifically targeted credits for low-income Canadians.
- A substantial broadening of both the personal and corporate tax base.
- The introduction of a BTT, both because of the substantial improvements in competitiveness that such a tax would provide Canadian industry and because the government proposes to raise a higher proportion of its revenue from commodity taxation. (The introduction of a BTT would be accompanied by low-income tax credits to ease the burden at the bottom of the income scale.)

Base Broadening

Most people still do not fully appreciate that, in order to get Canadian corporate and personal rates down to even shouting distance of those in the United States, Canada likely will have to undergo the trauma of a very widespread attack on tax preferences, business incentives, and miscellaneous deductions. Canada's tax structure is not as littered with boondoggles and tax preferences as was the U.S. system, and tax experts in the Finance Department will discover that they will have to throw overboard the great majority of Canadian tax preferences, as well as shift some of the income tax burden to a BTT, to achieve the desired reduction in Canadian rates.

On the personal tax side, the necessary base broadening almost certainly

will gobble up such items as the $1,000 dividend and interest exclusion, most tax shelter deductions, and some untaxed fringe benefits. The unlimited deduction of business and property interest expenses also will fall under review. Personal exemptions and deductions also are likely to be on the hit list, with some to be eliminated entirely and others to be converted into tax credits targeted for low-income groups. The $500,000 lifetime capital gains exemption is a cherished achievement of the present federal government, despite the well-directed criticism that economists and tax practictioners have poured on it. Despite base broadening, both this exemption and the individual minimum tax could well remain, although possibly in a cut-down form.

On the corporate side, now that the federal government's most recent budget already has swallowed the investment tax credits and inventory allowances, corporate base broadening will put the capital cost recovery system under very heavy pressure, with cutbacks in capital cost allowance rates on almost all assets likely under consideration. Possible changes in the capital cost allowance system could give rise to some of the biggest battles of the reform process. The present system has worked relatively well, and its perceived generosity is a recognition of the effects of inflation and obsolescence on capital replacements. But the depreciation rates the government suggested in 1985 for most machinery and equipment turn out to be less generous than those brought forward in the tight-fisted U.S. reform.

Other probable targets of corporate tax change could include a further review of preferred share financing and tax-free intercorporate dividends, some limitations on incentive resource deductions (at least for those not in the industry), a possible linking of the dividend tax credit to shareholders to the actual tax paid by the corporation, and a general all-round belt tightening. Unfortunately, the changes are not likely to provide for a full credit to shareholders for the corporate tax paid on distributed income, leaving Canada with an element of double taxation on corporate profits.

Only a few of the present corporate incentives are likely to escape, in whole or in part, but no government will want to tackle the current system of special treatment for Canadian small business. In addition, some encouragement for research and development spending could be maintained -- as it has in the United States -- given Canada's present weakness in that area.

Cutting Tax Rates: The Real Solution

Sharp reductions in corporate and personal tax rates, along with the inevitable broadening of the tax base, are essential steps in improving the efficiency of Canada's tax system and maintaining Canada's international competitiveness.

Lowering tax rates is the most effective action the government could take to provide a real incentive to all Canadians to improve economic performance. The accompanying broadening of the tax base will require a painful cutback in the investment-directing incentives and special treatment provisions that for so long have been a hallmark of our tax system, but it also will reduce government influence and control over the economy.

The change is likely to provide an important long-term, dynamic effect. Base broadening and rate reduction will mean a substantial reduction in marginal rates so that taxpayers, even though their present total taxes remain the same, can look forward to keeping a larger share of each additional dollar in income that they are able to earn.

Dangers and Problems

While the tax policy review that is now under way is not only necessary but

overdue, the whole tax reform process should be labeled "dangerous -- handle with care", for several reasons:

- The review may not be comprehensive enough. Too much time and effort is likely to be focused on the federal income tax rate structure and on progressivity, and far too little on the broad range of federal and provincial taxes -- payroll levies, capital taxes, sales taxes on business inputs, real estate taxes -- that give rise to some of the worst features of our present tax system.
- There is danger in embarking on fundamental tax reform without adequate preparation or consultation. The process has escalated in the past few months from a slow piecemeal review to a broad reform of at least the federal aspects of the total tax structure. Some changes, together with a program for future reform, are likely to be included in the next federal budget. Will the government have had sufficient input and time to deal with a major reform package?
- With the federal government running a deficit of over $30 billion, and the provinces adding at least half as much again, it will be hard to provide the generous transitional measures needed to ease the substantial shifts in burdens -- and resulting capital values -- that are being talked about.
- The field of federal-provincial cooperation is littered with monumental failures, and the provinces could become loose guns on the deck of Canadian tax reform by taking actions that work against the thrust of the federal reform measures. It will require firm federal leadership, considerable diplomacy, and a willingness to listen, as well as to talk, to get meaningful provincial cooperation.
- When it comes to tax policy, Canadians still have an abiding faith in the free lunch, the tooth fairy, and Santa Claus. Many politicians still believe they can buy lower tax rates for individuals -- who vote -- by loading taxes onto corporations -- which do not -- and that this shift will not cost anything in terms of investment and jobs.

In the U.S. reform package, some U.S.$120 billion will be shifted from individuals to corporations over a five-year period. Indeed, it is this planned shift that has permitted the buy-down of U.S. personal tax rates to such dramatically low levels. The shift may have an adverse effect on the U.S. economy, however, particularly in capital-intensive industries that already are suffering from foreign imports and declining markets. But a corresponding shift in Canadian tax burdens from individuals to corporations could have an even worse effect on Canadian competitiveness and employment. For one thing, Canadian business does not have available the broad range of boondoggles that used to litter the U.S. tax system. Second, Canadian business is already subject to high levels of taxation, although the bulk of such taxes are not income taxes but hidden taxes on corporate costs. Finally, industry in Canada has significantly higher capital costs, due to geography and demography, than it does in the United States, and the Canadian economy is more prone to boom and bust cycles because of its still-heavy reliance on primary resources.

Tax Reform Realities

This is a summary of what I consider to be some of the realities of tax reform in Canada:

- We cannot cut everybody's taxes at the same time; indeed, given present government deficits, total tax revenue cannot be cut at all. This means that the tax reform process must involve both winners and losers.
- The total Canadian tax burden cannot be reduced to U.S. levels; Canadians expect more government services than do Americans, and all Canadians must share the burden of that spending.
- It will be difficult to get personal and corporate rates down to levels even approaching those in the United States, although Canada clearly needs to move as far and as fast as it can in this direction for competitive reasons.

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- Business cannot expect to continue taking advantage of all its present incentives and tax expenditures while at the same time getting lower corporate tax rates. There must be a trade-off in terms of the base and the rates, with due care for the competitiveness of Canada's capital-intensive industrial and resource sectors.
- Tax reform must be approached in the same way that porcupines make love: carefully. The tax reform process can involve not only a redistribution of income but also a shift in capital values and a destabilization of expectations. Proposals for reform need to be put on the table and left there long enough for meaningful input. Appropriate and generous transitional measures need to be thought out, and realistic expectations need to be fostered as to what the reform process can produce.
- Canadians have to recognize that the tax system cannot be expected to deal with all of the perceived problems of regional inequalities, support for the arts, incentives to business, aid for the poor, and so on, and still achieve the desired broadened tax base and lower rates.
- Tax reform will not bring us a popular tax system. And on the other side of tax reform lies the ultimate issue of the appropriate level of government expenditure. This issue will be at least as important in the long term as how Canadians arrange to pay for that spending.

What Can Tax Reform Accomplish?

It is obvious that there are many dangers and difficulties in the tax reform process. It is equally obvious that all Canadians can really do, given our present deficits, is to redistribute the tax burden with winners and losers on each side. Despite these problems, however, the tax reform process does offer an opportunity to rationalize an important aspect of Canadian economic and fiscal policies in a way that provides broad, long-term benefits to the Canadian economy.

Successful tax reform must include sharply lower personal and corporate tax rates -- as close as possible to those in the United States -- and a broader and more neutral tax base. It should also involve a shift from personal income taxes to consumption taxes. Corporations should be asked to contribute at about present levels, but in a way that will maintain Canada's international competitiveness.

To achieve real progress in the current tax reform exercise, the federal government, and then the Canadian public, must be willing to accept an efficient, broadly based sales tax, such as a VAT,

as a permanent feature of the Canadian tax scene. If Canadians cannot stomach the political and administrative costs of such a reform and consumption tax, one that is capable of eliminating the defects of the present sales tax and of bearing part of the burden now placed on personal income taxes, our options for meaningful tax reform become much more limited.

Canadians must be prepared to address seriously the difficult question of how to integrate the personal tax structure and welfare system with the objective of providing targeted benefits to those who really need them and withdrawing welfare tax expenditures from those who do not. Canadians also must be willing to accept the pain and disruption that will come from base broadening and important shifts in tax burdens as part of the price to pay for a more efficient system. Canadian business and high-income individuals must accept that part of the price will have to be an improvement in the "optics" of the distribution of the tax burden: an acceptance that tax burdens must be shared out a bit more evenly if they are to be perceived as fair.

Given Canada's track record, there is considerable justification for some cynicism about whether Canadians have the will to face up to the hard choices that tax reform demands. But a thoughtful tax reform process could offer the opportunity of breaking out of the winners-and-losers syndrome, to a win-win situation. The most important aspect of the tax system's influence is its impact on efficiency, competitiveness, employment, and growth. The system must be fair, of course, and be perceived to be fair. In the long term, however, it is not the empty rhetoric of arguments about the distribution of the tax burden by industry or by income class that will be of overwhelming importance. Rather, the real answer to whether the tax system is fair is whether it enables Canada to provide the jobs, personal opportunities, and economic growth that will benefit all Canadians.

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